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Making a Case for Regulating Institutional Shareholders' Corporate Governance Roles

Iris H-Y Chiu * and Dionysia Katelouzou **

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Drawing on the disconnect that currently exists between the social expectations associated with the corporate governance role of institutions and the institutions' private interests, this article suggests that the current English legal framework does not adequately promote an optimal corporate governance role for institutions and does not meet the public interest of safeguarding investors' long-term saving needs and sustaining a sound wealth-creating corporate sector in the long term. Our starting point is that investor-led governance, as this is aspired by UK policy-makers, is not only a matter of achieving beneficiaries' private investment objectives through maximising long-term shareholder-value, but a matter of public interest. Next, we argue that existing regimes of private law that govern this area – first, the fabric of largely private law in contract and trust that governs the investment funds' relationships with their beneficiaries, and, secondly, the company law and corporate governance norms that govern investment funds' shareholder role – do not adequately take into account the public interest and, increasingly, are unable to meet the needs of private interests too. These inadequacies have only led to reinforcing a governance deficit for institutional shareholder behaviour and have left the dubious quality of institutions' behaviour to market forces. We suggest that institutions' shareholder behaviour should be governed in securities and investment management regulation and we outline the broad contours of how this may be achieved.

Introduction

Institutional investment, as a means to manage the savings of many, has grown to become a global socio-economic phenomenon over the last five decades. With state retreat from welfarism,¹ private savings and investment rose to become the key means for managing economic life and financial needs. The rise of pension fund management for retirement savings is arguably the key contributing factor to the phenomenon of saving through

* Professor of Corporate Law and Financial Regulation, Faculty of Laws, UCL.

** Lecturer in Corporate Law, Dickson Poon School of Law, King's College London.

¹ See, for example, P. Pierson, *Dismantling the Welfare State?* (Cambridge: Cambridge University Press 1994); M. Buti, D. Franco, L. R. Pench (eds), *The Welfare State in Europe* (Cheltenham: Edward Elgar, 1999) at 212ff.

privately-managed investment, both in the UK and globally.² As of 2015, the UK Financial Conduct Authority (FCA) estimates that there are 14.2 million pension savers in the UK, and 11 million retail investors.³ The FCA estimates that almost £6.6 trillion worth of assets are managed by UK-based investment fund managers.⁴ The size of the investment market is only one indication of the significant socio-economic footprint of investment management in ordinary economic life. At a micro level, the long-term success of savers' needs depends on the exercise of investment management discretion by fund managers. The implications of this realisation are also profound at a macro level as investment management discretion becomes a fundamental building block of an investment economy and performs the essential intermediation of savers' resources to long-term wealth creation purposes undertaken by the corporate, property or infrastructure sectors.⁵ This important intermediation role connects savers (the suppliers of capital) with economic 'incubators' or 'time machines', as Stout calls long-term wealth creating entities such as companies,⁶ (the demand side for such capital).

It should not come as a surprise, therefore, that institutional shareholder behaviour in the UK has attracted policy attention since the 1990s through a series of soft-law measures built upon independent Committee Reports⁷ and the more recent Stewardship Code.⁸ In overall, the key narrative in UK policy making has been an endorsement of shareholder engagement bound up in the private agency-based corporate governance framework under which institutions are placed in a position to monitor corporate performance and to increase managerial accountability through active corporate equity investment.⁹ Such active monitoring is perceived in the mainstream policy and academic circles as being able to improve corporate performance not only in the short- but also in the long-term.¹⁰ At the same time, investor-led corporate governance has been ushered in to improve financial returns for the ultimate beneficiaries of those assets of which institutions are trustees. Beyond this much hoped-for alignment between the corporate governance objective of shareholder-value increasing engagement on the one hand, and the accountability objective of improved returns for the ultimate beneficiaries on the other, it is increasingly perceived (especially following the global financial crisis of 2007-8) that institutional shareholders' engagement in investee

² G. L. Clark, 'Institutional Investors and Risk Management' in G. L. Clark, A. D. Dixon and A. HB Monk (eds), *Managing Financial Risks: From Global to Local* (Oxford: Oxford University Press, 2012) at chapter 3.

³ For statistics, see <https://www.fca.org.uk/your-fca/documents/infographic-assets-under-management> (all URLs were last accessed 20 September 2016).

⁴ *ibid.*

⁵ The rise of investment funds as economic allocators and their rise in power in the political economy is for, for example, discussed in A. Harness, *Unseen Power: How Mutual Funds Threaten the Political and Economic Wealth of Nations* (Canada: Stoddart, 2001).

⁶ L. Stout, 'The Corporation as Time Machine: Intergenerational Equity, Intergenerational Efficiency, and the Corporate Form' (2015) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2556883.

⁷ Official endorsements of shareholder engagement in the UK include: the Cadbury Report 1992 (Report of the Committee on the Financial Aspects of Corporate Governance); the Hampel Report 1998; the Combined Code 2000; the Higgs Review (of the role and effectiveness of non-executive directors) 2003; the Institutional Shareholder's Committee 2002 statement of principles; the Myners 2001 Report (P. Myners, *Institutional Investment in the United Kingdom: A Review*) and the Kay Review 2012 (BIS, *The Kay Review of UK Equity Markets and Long-Term Decision Making*, Final Report, 23 July 2012).

⁸ The UK Stewardship Code, Financial Reporting Council (2012), at <https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx>.

⁹ Myners Report, n 7 above; Kay Review, n 7 above.

¹⁰ *Ibid.*

companies by managing the long-term financial interests of savers is key to ensuring that in the long-term savers' needs and the corporate sector's needs are both met in such a way that delivers overall social benefit.¹¹ The underlying rationale for the official endorsement of investor-led governance in the UK is, in our view, tripartite: (i) attentiveness to the performance of investee companies over the long term on the basis of the private agency paradigm of corporate governance, (ii) commitment to the ultimate beneficiaries' investment needs on the basis of the private trusteeship relationship that governs the investment funds' relationships with their beneficiaries, and (iii) adherence to broader public regulatory objectives associated with the long-term savers' needs. The importance of investment funds' corporate governance roles is, therefore, not only a matter of achieving beneficiaries' private investment objectives through maximising long-term shareholder-value, but a matter of public interest.

Such investor-led governance relies, therefore, on the validity of at least two claims. First, it must be the case that investor-led governance can indeed improve the performance of investee companies in the long-term. Secondly, it must be the case that a strong performing corporate sector in the long term can offset the costs of active monitoring for investment managers and thereby better serve the interests of the institutions' clients. Both claims have attracted an enormous amount of attention from scholars who are divided over the desirability of investor-led governance.¹² The aim of this article is not to engage in these debates or make an assessment of the performance aspects of investor-led governance. Rather, our goal is to scrutinise the public interest aspect arising out of the corporate governance role of institutions as there is reason to believe that even if institutions conform to the policy aspirations of performing the monitoring function envisaged by the private agency corporate governance paradigm and serving the interests of their clients, they may jeopardise the investment hopes of the ultimate savers. This third facet underlying the official endorsement of investor-led governance in the UK imposes a rethinking of the nature of investor-led governance as reflecting socio-political dimensions of public interests. But such public interests are not in our view currently reflected in the private law governing the corporate governance role of institutions. We argue, therefore, that the public interest found in the corporate governance role of institutions can find more overt articulation in the development of regulatory duties under securities and investment regulation.

The rest of the article proceeds as follows. In the first part, we outline the public interest aspects arising out of the corporate governance role of institutions and emphasise the practical challenges posed to such a role. We then argue in the second part of this article, that the private law of obligations in trust and contract that governs the relationships between the funds and their savers is increasingly unable to address those public interest concerns as they do not deal adequately with the collective nature of investment management, the growth of the investment chain and the public interest consequences of long-term investment. We then

¹¹ Kay Review, n 7 above.

¹² See, for example, P. L. Davies, 'Institutional Investors in the United Kingdom' in D. D. Prentice and P. R. J. Holland (eds.), *Contemporary Issues in Corporate Governance* (Oxford: Clarendon Press, 1993), 69-96. For a similar debate in the US, see B. Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice', *UCLA Law Review*, 39 (1992), 811; J. C. Coffee Jr., 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor', *Columbia Law Review*, 91 (1991), 1277; R. J. Gilson and R. Kraakman, 'Reinventing the Outside Director: An Agenda for Institutional Investors', *Stanford Law Review*, 43 (1991), 863.

turn to the company law and corporate governance framework governing the expectations and behaviour of institutions as shareholders, and contend that the overall policy support for shareholder empowerment in the UK and the soft law of stewardship fails to adapt to the changing profile of shareholder as that of institutions and is overwhelmingly focused on shareholders' private interests disregarding wider public interests. As a result, investment management discretion, and its attendant principal-agent problems¹³ amplified by virtue of its socio-economic footprint, is an area riddled by governance deficits. To address these governance deficits, the article's final part sets out a case for introducing regulation for institutional shareholders' governance role. Although regulation is not always a panacea for governance deficits, we are of the view that meaningful aspects of securities regulation and investment management regulation can be extended to institutions' corporate governance roles. We view the development of such a regime as a means of taming the corporate power of institutions, addressing the governance concerns associated with the exercise of contemporary forms of shareholder activism and serving the public interest associated with investor-led governance. Our proposed regulatory approach, despite being antithetical to the UK tradition of self-regulation in corporate governance, marries together the public-private paradigms, the common interests of investor protection and shareholder conduct, and it can be supported on public policy grounds of making investment management long-termism and accountable.

I. The Public Interest Aspects of the Corporate Governance Role of Institutions: Expectations and Challenges

During the 1970s and 1980s the proportion of UK equities owned by institutional investors increased dramatically and by the early 1990s, traditional institutional investors held the bulk of UK equities, with pension funds being the largest category, with almost a third.¹⁴ Despite the decline in the share of equities owned by UK pension funds in the years that followed, the overall institutional ownership of UK equities reached new heights in the 2000s because of the increase in overseas institutional investors.¹⁵ As owners of corporate equity, funds and their asset managers become shareholders of companies. Not only do they assume legal rights under company law, but institutional ownership of corporate equity has been an important driving factor for the adoption of the centrality of shareholder value as a corporate objective.¹⁶

¹³ A. M. Paces, 'Financial Intermediation in the Securities Markets Law and Economics of the Conduct of Business Regulation' (2000) 20 *International Review of Law and Economics* 479. Modern investment management structures create unique principal-agent problems and lacunae in accountability that will be further canvassed in the article.

¹⁴ For statistics between 1997 and 2012, see http://webarchive.nationalarchives.gov.uk/20160105160709/http://www.ons.gov.uk/ons/taxonomy/search/index.html?newquery=*%&nscl=Shareholdings+by+Individuals&nscl-orig=Shareholdings+by+Individuals&content-type=publicationContentTypes&sortDirection=DESCENDING&sortBy=pubdate

¹⁵ *ibid.*

¹⁶ E. Stockhammer, 'Financialization and the Slowdown of Accumulation' in I. Erturk, J. Froud, S. Johal, A. Leaver and K. Williams (eds), *Financialization At Work: Key Tests and Commentary* (London: Routledge, 2008); P. Ireland, 'The Financialization of Corporate Governance' (2009) 60 *Northern Ireland Legal Quarterly* 1.

The shareholder primacy rhetoric in corporate law which began life in economic terms (as a result of the efficient organisation of the company),¹⁷ has increasingly become a political phenomenon.¹⁸ Although the investment fund industry comprises of different types of funds whose mandates are heterogeneous, the embrace of shareholder centricity is advantageous to them,¹⁹ and we see a high-level convergence of shareholder behaviour around the common theme of the primacy of funds' financial interests in their investment management. The main investment fund vehicles today can be classified into certain large clusters of equity-owning funds: pension funds, mutual funds/retail collective investment schemes (many of which are UCITs), alternative investment funds such as hedge and private equity funds and sovereign wealth funds.²⁰ Although each cluster does not behave homogeneously as equity-owners, one of us in another work²¹ argues that at a high level, institutions orient their corporate governance roles towards their performance needs, usually in the short term, and very rarely are cognisant of broader, systemic and long-term implications. Pursuant to such an approach, funds may indeed adopt on the face of it, different types of corporate governance behaviour, ranging from passive ownership to active engagement or shareholder activism.²² However, the overall insularity of their approaches is disengaged from the wider concerns for savers and the long-term corporate economy, and is mainly driven by the institutions' own profit maximisation.²³ Hence, the examination of the institutions' shareholder behaviour raises a range of different concerns when we remind ourselves of the social framing of their long-term roles and the wider public interests associated with their corporate governance role.

The dominant law-and-economics academic community of the last 25 years is of the view that institutional shareholders, especially after the re-concentration of public equity in their hands, are best able to keep management honest and focused on long-term corporate value maximisation.²⁴ This view is based on the private agency paradigm of corporate governance which mainly deals with internal accountability primarily to shareholders/principals.²⁵ Under this framework, shareholder monitoring can mitigate managerial/agent abuse and thereby

¹⁷ F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1948); J. Fisch, 'Measuring Efficiency In Corporate Law: The Role of Shareholder Primacy' (2005) 31 *Journal of Corporation Law* 637.

¹⁸ See H. Hansmann and R. Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Journal* 439; M. Gelter, 'The Pension System and the Rise of Shareholder Primacy' (2013) 43 *Seton Hall Law Review* 910. In the UK, Armour and others argue that shareholder primacy is a powerful norm but somewhat mitigated by Europe's pro-stakeholder agendas; see J. Armour, S. Deakin and S. Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41 *British Journal of Industrial Relations* 531.

¹⁹ In fact, a number of commentators have opined that institutions are powerful in shaping modern corporate governance norms in favour of shareholder centricity which is consistent with their preferences, see M. Siems, 'Convergence in Corporate Governance: A Leximetric Approach' (2010) 35 *Journal of Corporation Law* 729; C. Gerner-Beuerle, 'Determinants of Corporate Governance Codes' (2014), at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2346673.

²⁰ * and **, *Investment Management and Corporate Governance* (Cheltenham, UK: Edward Elgar, 2017 forthcoming).

²¹ *ibid.*

²² T. McNulty and D. Nordberg 'Ownership, Activism and Engagement: Institutional Investors as Active Owners' (2016) 24 *Corporate Governance: An International Review* 346.

²³ See also J. Hendry, P. Sanderson, R. Barker and J. Roberts 'Responsible Ownership, Shareholder Value and the New Shareholder Activism' (2007) 11 *Competition & Change* 223 (qualitatively finding that the main driving force behind shareholder activism in the UK is the institutions' own profit maximisation and the need to outperform competing institutions).

²⁴ See citations in fn 12.

²⁵ M. Jensen and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

benefit other constituents in the corporate governance framework, such as creditors and employees. Shareholders' corporate governance roles are, therefore, seen as an integration of their private interests with the wider social/public interest in a well-performing corporate sector not riddled with scandals.

Of course, this view is not universally shared and it is often argued that shareholder incentives are incompatible with active engagement as a force for governance as the shareholders' interests are at odds with long-term management in the interests of stakeholders.²⁶ Preoccupied with one side of this debate policy makers in the UK have mainly looked at the corporate governance role of shareholders²⁷ emphasising the social benefits of more constructive shareholder engagement by institutions.

The Myners Report in 2001²⁸ and the more recent Kay Review of 2012²⁹ aim to bolster investor-led governance on the premise that institutional shareholder engagement is part of good corporate governance for the public interest and not merely for the benefit of the institutions themselves. Also, the Walker Review³⁰ considered investor-led governance as being relevant to monitoring management in UK banks and financial institutions. The mainstream view in UK policy circles (especially after the global financial crisis) is that shareholder monitoring does not only serve shareholder value maximisation and the private interests of asset managers' clients but there is a public interest in the discharge of the responsibilities of institutional shareholders as owners, an 'implicit social legitimacy',³¹ which found ultimate expression in the stewardship responsibilities introduced by the UK Stewardship Code.³² These wider benefits to the public can accrue as a result of a strong long-term performance of UK companies and the ability of ultimate beneficiaries (savers) to benefit from this performance through returns to indirect (but also direct) ownership of shares in UK companies.

However, the UK securities market is marked by distinctive features that pose challenges to this vision of constructive investor-led governance for the public interest. The UK not only has a largely dispersed shareholding structure in its corporate economy but a globally competitive and highly liquid stock market.³³ Although institutions (mainly foreign ones) are

²⁶ Discussed in D. Katelouzou 'Reflections on the Nature of the Public Corporation in an Era of Shareholder Activism and Shareholder Stewardship' in B. Choudhury and M. Petrin (eds.), *Understanding the Modern Corporation* (Cambridge: Cambridge University Press, 2016 Forthcoming) (arguing for a shift towards an 'investor paradigm' in corporate law which calls for both shareholder monitoring and shareholder responsibility, bringing together owner control and social accountability).

²⁷ But see Department for Business, Energy and Industrial Strategy, Corporate Governance Reform Green Paper, November 2016, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/573438/beis-16-56-corporate-governance-reform-green-paper-final.pdf

²⁸ Myners Report, n 7 above.

²⁹ Kay Review, n 7 above.

³⁰ D Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations (26 November 2009).

³¹ Ibid.

³² See text to notes 124-44 below.

³³ See, generally, B. C. Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford: OUP, 2008)

now the dominant shareholders in UK corporate equity,³⁴ the UK shareholding structure remains largely dispersed with many institutions holding only small minority stakes. Berle and Means opined as early as in the 1930s that dispersed minority equity owners were likely to be passive investors who would likely take no sense of ownership of the wider implications of companies as wealth-creating institutions for the economy and society.³⁵ Indeed, passivity and lack of engagement still characterises most UK institutional investors and asset managers who mainly focus on trading on the liquid securities markets in order to generate investment returns.³⁶

On the other side of the spectrum, encouraging institutions to engage for the public interest is not a panacea. Neville³⁷ suggests that what is socially beneficial is a balanced and a ‘right type’ of shareholder engagement that concurrently achieves the institution’s private objectives aligned with socially beneficial objectives in the long term. But such an alignment is, in our view, a misplaced assumption, a hope. Unbridled shareholder activism, unleashed of any regulatory constraints, would primarily serve institutions’ private interests. For example, ‘investor myopia’ on the part of institutions has already been observed by academics and policy-makers.³⁸ Evidently institutional investors’ obsession with short term investment performance is key to their investment management practice.³⁹ Thus, even where institutions support shareholder engagement, such engagement is on the basis of a shareholder value ideology⁴⁰ that exerts short-termist pressures upon their investee companies and has deleterious effects upon corporate culture, bringing in short-termism and less regard for stakeholders and wider social responsibility.

Pursuant to shareholder demands, corporations are increasingly pressured to generate earnings in order to keep share prices up from quarter to quarter.⁴¹ Corporate short termism is defined as behaviour that is dedicated to short term strategies to keep earnings high whether or not such strategies result in value destruction for the company in the long-term.⁴² Corporate short termism, such as reducing employment expense and R&D investment in order to boost short-term earnings, obscures long-term thinking for the company and in due course could prove destructive for the long-term wealth creation role of the corporate

³⁴ This refers to both domestic and foreign institutions, with the latter outstripping the former in terms of ownership of UK corporate equity. See ONS, *Holdings of UK Quoted Shares by Sector of Beneficial Owner* (2015) at <http://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofukquotedshares/2015-09-02>.

³⁵ A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (New Brunswick, US: Macmillan 1932), 66.

³⁶ Cheffins, n 33 above.

³⁷ M. Neville, ‘The Suspicious Shareholder’ in H. Birkmose, M. Neville and K. Engsig Sørensen (eds.), *The European Financial Market in Transition* (Alpen aan den Rijn: Kluwer Law International, 2011).

³⁸ Kay Review, n 8, above; C. Mayer, *Firm Commitment* (Oxford: Oxford University Press, 2013).

³⁹ See Aspen Institute, *Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management* (2009) at <http://www.aspeninstitute.org/publications/overcoming-short-termism-call-more-responsible-approach-investment-business-management>; C. Helms, M. Fox and R. Kenagy, ‘Corporate Short-Termism: Causes and Remedies’ (2012) 23 *International and Comparative Company Law Review* 45.

⁴⁰ See citations in fn 18.

⁴¹ See, for example, P. E. Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013).

⁴² See citations in fn 39.

economy.⁴³ Corporate short-termism may be regarded as a response to the demands of institutional shareholders, whose focus is on trading in generating investment returns and is contrary to and indeed damaging to the prospects of long-term saving through investing in corporate equity.⁴⁴ Further, commentators⁴⁵ find corporate short-termism to be related to greater indifference to stakeholder or corporate responsibility issues, and institutions lack motivation to address social and environmental harms that the company is perpetuating. Moore and Walker-Arnott argue that such short-termist trading behaviour is ultimately socially harmful as it involves perpetual transfers of future wealth to the present to meet short-termist needs, and will ultimately undermine long-term investment performance and the long-term prospects and cost of capital of the corporate sector.⁴⁶ Such short-termist investment gains can be disengaged from real productivity gains and depart from the model of patient capital-investing in corporations.⁴⁷ Pervasive short-termism is, therefore, a matter of wider public interest relating to the future of the corporate economy and the productivity of long-term savings invested in corporate equity.

Finally, new movements in shareholder behaviour have also uttered a threat to the public interests associated with the corporate governance role of institutions. At the turn of 21st century, we saw a handful of hedge fund managers turning to corporate governance as an investment strategy and engaging – sometimes very aggressively – with firms where management is not capable of maximizing the value of the current assets.⁴⁸ Such activism leverages upon existing shareholder rights in domestic company law frameworks throughout the world,⁴⁹ and is supported by a shareholder primacy rhetoric. American scholars Iman Anabtawi and Lynn Stout warn of the informal but powerful influences minority activists can wield even if these are not strictly exercises of any legal power.⁵⁰ Such influences are particular powerful as institutional shareholder activism, and especially hedge fund activism, affects the securities markets acutely,⁵¹ and modern companies reliant on capital markets are tremendously sensitive to effects transmitted from the securities markets. Although

⁴³ E. Duruigbo, 'Tackling Shareholder Short-Termism and Managerial Myopia' (2011-12) 100 *Kentucky Law Journal* 531.

⁴⁴ Kay Review, n 7, above.

⁴⁵ D. Millon, 'Shareholder Social Responsibility' (2012-13) 36 *Seattle University Law Review* 911; E. Duruigbo, 'Stimulating Long-term Shareholding' (2011-12) 33 *Cardozo Law Review* 1734.

⁴⁶ M. T. Moore and E. Walker-Arnott, 'A Fresh Look at Stock Market Short Termism' (2014) 41 *Journal of Law and Society* 416.

⁴⁷ D. T. Mitchell, 'Institutional shareholders as Proxies: The Contours of Shareholder Democracy' (2006) 65 *Washington and Lee Law Review* 4.

⁴⁸ I. H-Y Chiu, *The Foundations and Anatomy of Shareholder Activism* (Oxford and Portland, Oregon: Hart Publishing, 2010), chapters 1 and 2; D. Katelouzou, 'Myths and Realities of Hedge Fund Activism: Some Empirical Evidence' (2013) 7 *Virginia Business and Law Review* 459.

⁴⁹ D. Katelouzou, 'Worldwide Hedge Fund Activism' Dimensions and Legal Determinants' (2015) 17 *University of Pennsylvania Law Review* 789.

⁵⁰ I. Anabtawi and L. Stout, 'Fiduciary Duties for Activist Shareholders' (2008) *Stanford Law Review* 1255. See also a somewhat dubious piece that argues that influential minority activists could amount to shadow directors and thus should be subject to the same fiduciary duties: D. W. Giattino, 'Curbing Rent-Seeking by Activist Shareholders: The British Approach' (2011) 25 *Temple International & Comparative Law Journal* 103.

⁵¹ Much empirical research has pointed out how activist stakes affect security prices from the time of announcing the stake, even before activism has begun, see A. Brav, W. Jiang, F. Partnoy and R. Thomas, 'Hedge Fund Activism, Corporate Governance, and Firm Performance' (2009) 63 *The Journal of Finance* 1729-1775; M. Becht, J. Franks, J. Grant and H. F. Wagner (2015) 'The Returns to Hedge Fund Activism: An International Study', at <http://ssrn.com/abstract=2376271>.

shareholder activism does not relate to legal power over corporate property,⁵² activist influence over management may not be understated. The effects of such shareholder activism are also not unequivocally optimal.⁵³ There is a very vivid scholarly and public debate about the perceived ‘dark side’⁵⁴ of hedge fund activism and over whether the effects of activist hedge fund campaigns are ‘real’⁵⁵ — that is, whether activist hedge funds have a long-term effect on firm ‘fundamentals’ that lasts beyond the short-term market reaction or whether activist hedge fund interventions reflect unsustainable changes that will not translate into long-term improvement of the corporate performance. Even though no study has concluded that hedge fund activism destroys near-term shareholder value,⁵⁶ it is still questionable whether activist hedge funds can act ‘like real owners’,⁵⁷ or as a ‘corrective mechanism’ in corporate governance.⁵⁸ It is, therefore, doubtful whether hedge funds’ engagement practices can be cognizant of wider public interests in their corporate governance role.⁵⁹ Such a detachment becomes all the more significant as with the increase of activist hedge funds, institutional shareholder activism also took shape: mainstream institutional shareholders, such as pension funds, become increasingly willing to support activist hedge funds’ campaigns, but are unlikely themselves to initiate them.⁶⁰

There is, therefore, a disconnect between the social expectations associated with the corporate governance role of institutions and the institutions’ private interests, which raises important questions in terms of the dominance of institutions’ private interests, their mixed impact on investee companies, and the dubious quality of their active role in corporate governance. Despite the socio-economic ramifications of institutional shareholder roles in corporate governance, policy-makers in the UK have naively supported shareholder centrality and engagement and have not considered that unleashing active shareholder behaviour requires a balanced antithetical consideration in terms of their due governance.

⁵² P. J. Dalley, ‘Shareholder (And Director) Fiduciary Duties and Shareholder Activism’ (2008) 8 *Houston Business and Tax Law Journal* 301, 302.

⁵³ See, among others, W. W. Bratton, ‘Hedge Funds and Governance Targets’ (2007) 95 *Georgetown Law Journal* 1375; W. W. Bratton and M. L. Wachter, ‘The Case Against Shareholder Empowerment’ (2010) *University of Pennsylvania Law Review* 653; L. E. Strine, Jr., ‘One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?’ (2010) *Business Lawyer* 1; Wachtell, Lipton, Rosen & Katz, ‘Empiricism and Experience; Activism and Short-Termism; the Real World of Business’ (2013) at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.22899.13.pdf>; L. E. Strine, Jr., ‘Can We Do Better By Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law’ (2014) *Columbia Law Review* 449;

⁵⁴ Katelouzou, n 48 above.

⁵⁵ A. Brav, W. Jiang and H. Kim, ‘The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Industry Concentration’ (2013), at <http://econ.as.nyu.edu/docs/IO/30891/AlonBrav.pdf>.

⁵⁶ For a recent literature review on all major studies on whether (US and non-US) hedge fund activism creates value, see A. Brav, W. Jiang and H. Kim, ‘Recent advances in research on hedge fund activism: Value creation and identification’ (2015) 7 *Annual Review of Financial Economics* 579.

⁵⁷ M. Kahan and E. Rock, ‘Hedge Funds in Corporate Governance and Corporate Control’ (2007) 115 *University of Pennsylvania Law Review* 1021.

⁵⁸ P. Rose & B. Sharfman, ‘Shareholder Activism as a Corrective Mechanism in Corporate Governance’ (2014) *Brigham Young University Law Review* 1015.

⁵⁹ D. Katelouzou ‘Hedge Fund Activism and Shareholder Stewardship: Incompatible, Reciprocal or Something in Between?’ Working Paper (in file with the authors).

⁶⁰ R. J. Gilson and J. N. Gordon, ‘The Agency Costs of agency Capitalism: Activist Investors and the Reevaluation of Governance Rights’ (2013) *Columbia Law Review* 863.

II. The Increasing Inadequacies of Private Law to Address the Public Interest Aspects of Institutions' Corporate Governance Roles

Modern investment management is largely governed by a web of private law obligations in contract, trust and tort law.⁶¹ In a simple paradigm where an individual investor entrusts to a skilled investment intermediary to manage her investment, such intermediary's relationship with the investor is governed by the agency agreement whose contractual terms form the basis of investment objectives and the intermediary's investment powers, as well as by standards of conduct in fiduciary and tort law. The relationship between the investor and intermediary, characterised by the investor's reliance on the professional skill of the intermediary, and the intermediary's powers to have custody of and deal with the investor's money and assets, falls within the category of 'fiduciary relationships',⁶² which require the intermediary to act in a way that is loyal to the investor and not to harm her interests.⁶³ This largely proscriptive standard is, however, not absolute and has evolved as a balancing act between investors' interests and the intermediary's commercial interests as discussed below. Further, as the intermediary is a skilled investment professional, it is held to a standard of care and skill that is reasonably expected of such profession.⁶⁴ Overtime, the standard of care and skill has become more specifically articulated in regulatory duties in the UK and US, relating to prudence and portfolio diversification.⁶⁵

In this Section we argue that modern investment management governed by private law is increasingly irrelevant to the public interest aspects of institutions' corporate governance roles. The private law paradigms might be sufficiently wide to encompass a range of investment management actions that institutions carry out, including outsourcing and assumption of corporate governance roles.⁶⁶ However, we are of the view that the industry structures of institutional investment increasingly alienates institutions' corporate governance roles from beneficiaries. This disengagement has profound implications for the nature of institutions' corporate governance roles. We point to two key developments in the changing relational paradigm between investors and their investment intermediaries. The first development is the rise of collective investment management as the primary way to manage myriad savers' capital. The pooling of savers' capital into a collective entity that is managed

⁶¹ Major references in investment management law in the US and UK, the two largest investment fund management jurisdictions globally, deal with the bedrock of contractual terms, fiduciary obligations and duties of care and skill, supplemented to an extent by legislation in both jurisdictions. See, for example, T. Spangler, *Investment Management Law* (Oxford: OUP, 2008); L. van Setten, *The Law of Institutional Investment Management* (Oxford: OUP, 2009); D. Busch and D. Demott (eds), *Liability of Asset Managers* (Oxford: OUP, 2012).

⁶² See Spangler, *ibid*, at para 4.26-4.45; van Setten, *ibid*, at paras 3.60-3.69.

⁶³ The proscriptive nature is explained in *Bristol and West Building Society v Mothew* [1998] Ch 1 at 18. See discussion and citations in Law Commission, *Fiduciary Duties of Investment Intermediaries* (June 2014) at paras 3.12, 3.13.

⁶⁴ See distinction made between the duty of loyalty and care in *Seymour v Christine Ockwell & Co & ors.* (2005) PNLR 39, and general law applies in terms of professional standards of care, see *Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582.

⁶⁵ UNEP Finance Initiative, *A Legal Framework for Integrating Environmental, Social and Governance Issues into Institutional Investment* (2005) at 8.

⁶⁶ E. McGaughey, 'Does Corporate Governance Exclude the Ultimate Investor?' (2015) 16 *Journal of Corporate Law Studies* 221.

by the investment intermediary results in the augmentation of intermediary power while marginalising each investor's preferences. Second, the structure of investment management, which has developed into chains of specialist services, dilutes the extent of private law obligations owed to investors and investors' recourse. The investment chain structure inevitably disengages and disempowers investors from monitoring and feeding their preferences into the investment management function. This results in institutions' taking on corporate governance roles not as a reflection of the beneficiaries' preferences, which could inculcate long-termism and the social interest in sustainable corporate wealth creation, but as a means to serve the institutions' own investment performance interests which are not always aligned with the beneficiaries' long-termist and socially minded interests.

The Rise of Collective Investment Management

The first development pointing to the disconnection between ultimate beneficiaries and the institution's corporate governance role is that investment management has increasingly become a *collective* investment management phenomenon. Collective pooling of savings into investment funds ensures sufficiently affordable access to investment due to economies of scale. Collective investment management creates access to investment for the ordinary saver in the street, but this gives rise to standardisation in the relational dimension between investment intermediaries and investors and therefore (ironically) less prospect for tailor-made financial solutions to specific needs. The rise of the collective investment management phenomenon is widely supported in the face of the retreat of state welfarism in individual financial provision.⁶⁷ Furthermore, in the latter part of the twentieth century, legal changes that weakened the application of the full extent of private law, such as in fiduciary duties, have taken place to further support the dominance of collective investment management.

Collective investment management would, in the absence of legal and regulatory intervention, face severe limitations due to the application of fiduciary law. Fiduciary law ensures that the entrusted entity acts in loyalty towards the investor and is proscribed from acting against or being in a position of conflict with the investor's interest.⁶⁸ The strict application of fiduciary law would make it difficult for collective investment management to be carried out as there may be conflicts of interest between investors. Further, such strict application would also make it impossible for fund managers to manage more than one fund as there may be conflicts of interest between funds, between managers and fund investors, and between investors.⁶⁹

Legal and regulatory inroads have persistently been made into the strict application of fiduciary law. By the early 1990s, it had become increasingly accepted in the UK that the intermediary nature of certain businesses could give rise to potential conflicts of interests.⁷⁰ The financial sector was nevertheless of the view that there was no prohibition of conflicts of interests, so avoiding them was not necessary.⁷¹ However, the uncertainty in the application of the general fiduciary principle to financial transactions would cause increased 'legal risk' that was inimical to the interests of the industry. As such, the industry lobbied to support

⁶⁷ See, for example, G. L. Clark, *Pension Fund Capitalism* (Oxford: OUP, 2000).

⁶⁸ Van Setten, n 78 above at paras 3.60-3.63.

⁶⁹ The dimensions of conflicts of interest are discussed in G. Palazzo and L. Rethel, 'Conflicts of Interest in Financial Intermediation' (2008) 81 *Journal of Business Ethics* 193.

⁷⁰ For example, intermediaries acting for both sides of a transaction, examples are discussed in Law Commission, *Fiduciary Duties and Regulatory Rules* (Law Com CP No 124, 1995).

⁷¹ See, for example, the Privy Council decision in *Kelly v Cooper* [1993] AC 205 (PC).

limitations in private law remedies for clients in breach of contract, breach of fiduciary or statutory duties, or tort liability.⁷² The English Law Commission, in its 1995 report, concluded that the general law on fiduciary duties had limited application to the financial sector.⁷³ Qualifications in applying fiduciary duties to many commercial contexts had been developing in the UK case law.⁷⁴ The Law Commission expressed the view that as there were nascent regulatory rules governing the conduct of financial intermediaries, these regulatory rules should be read as contractual usages modifying the nature and scope of any fiduciary duty.⁷⁵ The clarification provided by the Law Commission meant that financial institutions could contractually delineate the scope of their fiduciary liability *vis-à-vis* clients, within the scope of the regulatory principles, and that this would be accepted in courts as the substance and extent of any duty owed to clients.⁷⁶ General fiduciary law is now of limited relevance to governing the management of conflicts of interest in financial firms. Hanrahan, writing in the Australian context, rightly points out that general fiduciary law is no longer able to provide the ‘public good’ of client protection with respect to regulating conflicts of interest.⁷⁷

Regulators have introduced a regulatory regime for conflicts of interest management for financial firms, both as a means of clarifying their safe scope of business, as well as to provide investor protection to some extent. However, the regulatory regime arguably manifests the unwillingness of policymakers to unduly restrain financial intermediary business.⁷⁸ The approach adopted in the UK allows financial firms to identify, manage and disclose conflicts of interest,⁷⁹ without being excessively prescriptive.

In this paradigm of collective investment management, investors no longer buy into a relationship with their investment intermediaries. Rather, they buy into a product created by intermediaries, which is a distinct and usually incorporated entity that holds the pool of capital managed by the intermediary. The relational paradigm in contract and trust law which frames investors’ and intermediaries’ relationship as one of professional delegation and accountability is increasingly being eclipsed by the reality of intermediary domination in defining investors’ nature of participation. Investors are disempowered and disaggregated constituents of a collective investment vehicle that assumes its own identity in conducting

⁷² J. J. Dalhuisen, *Transnational and Comparative Commercial, Financial and Trade Law*, vol III (5th edn, Oxford: Hart Publishing, 2012), chapter 2.

⁷³ See Law Commission, *Fiduciary Duties and Regulatory Rules* (Law Com CP No 124, 1995).

⁷⁴ *ibid.*

⁷⁵ But this would remain subject to judicial review, see *ibid.*

⁷⁶ Blanket exclusions are not allowed, see *Brandeis (Brokers) Limited v Herbert Black, American Iron and Metal Company Incorporated, Lito Trade Incorporated*, 2001 WL 513189. But see G. McCormack, ‘Conflicts of Interest and the Investment Management Function’ (1999) 2 *Company Lawyer* 2.

⁷⁷ P. F. Hanrahan, ‘Fiduciary Duty and the Market: Private Law and the Public Good’ (2008), at <http://ssrn.com/abstract=1184443> (writing in the context of the Australian Securities and Investment Commission’s failed action in fiduciary duty against Citigroup and arguing that the private law of fiduciary duty is increasingly likely to tolerate contractual modifications, especially in contracts between sophisticated investors).

⁷⁸ R. R. West, ‘Conflicts of Interest: Substance or Subterfuge?’ (1971) 27 *Financial Analysts Journal* 31.

⁷⁹ UK law comes from Art 23, Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast), derived from European Parliament and Council Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L145/1 (Markets in Financial Instruments Directive, MiFID), art 18. That said, there are specific regulatory rules for inducements, Art 24 of the MiFID 2014 Directive and for investment research.

corporate governance roles vis a vis investee companies. Investors become passive and likely lacking in concern with respect to the wider social purposes of investing for the long-term. This is not desirable as institutions may cease to reflect socially-minded purposefulness in their investment management, which explains the postures of short-termism and instrumentalism in their corporate governance roles discussed above.

Even if in principle, private law paradigms do not prevent beneficiaries from instructing institutions to take certain corporate governance positions,⁸⁰ we query whether it is practicable or appropriate for one or several like-minded beneficiaries in the fund to influence the fund's overall corporate governance position. The collectivisation of investment management provides no incentives for any particular beneficiary to take such initiatives, a problem known as the collective action problem. Further, it may be arguably inconsistent with duties of care or fiduciary duty for the fund to be captured by a particular beneficiary's initiative. Hence, the collectivisation of investment management via a pooled capital structure such as a fund not only distances investors from the practices of investment management including the fund's corporate governance roles, but also creates a diffused and uncertain context for beneficiaries to express any particular preferences. This, in effect, leaves funds' corporate governance positions to be determined by funds, not their savers, and in practice, it would be the fund manager that exercises such discretion, as will be discussed below.

The Growth of the Investment Chain

The second, related, development concerns the increasing complexity of investors' relationships with their intermediaries, as manifested in the growth of the investment chain.⁸¹ In the investment chain, funds are separated from fund management, and other specialist services that complement the fund management function such as trading, research, custody, depositary, prime brokerage etc.⁸² The investor's relationship is with the fund, to which the private law obligations referred to earlier apply. However, there is no direct relationship between the investor and other service providers appointed by the fund. As the fund entity appoints the management company to invest and manage the fund assets, and other services in terms of brokerage, advice, custodial and other services, investors in a fund do not have a direct legal relationship with any of entities that manage or operate the fund on a day-to-day basis, chief of whom is the fund manager who is crucial for making strategic and operational decisions in relation to the investment management of the fund's assets. Such a structure of 'separation of funds from management' can be observed in pension funds, which outsource investment management to various portfolio managers,⁸³ retail collective investment funds such as the popular UCITs, hedge and private equity funds.

Despite any efficiency gains of the separation of fund from management,⁸⁴ such a structure is likely to be legally disadvantageous to investors, as the investor protection they

⁸⁰ McGaughey, n 67 above.

⁸¹ Kay Review, n 7 above, at chapter 6.

⁸² For an account of why investors and fund managers converge upon accepting this structure based on efficiency reasons, see J. Morley, 'The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation' (2013-14) 123 *Yale Law Journal* 1228.

⁸³ Whether in relation to defined benefit or contribution schemes, employers' fund entities often appoint outside investment managers for portfolios.

⁸⁴ These include protection of investors from fund managers' costs and liabilities or from spillages of risk from other management mandates; better investor rights, for example, by offering good and certain exit terms; and economies of scale as this structure allows fund managers to operate many funds, thereby lowering fees for all

enjoy under duties of care⁸⁵ and relevant fiduciary law⁸⁶ would only be owed by the fund entity and not the fund manager or other entities that the fund contracts with. For example, the UK Pensions Act 1995 imposes on pension trustees duties of care.⁸⁷ Pension trustees often seek to delegate to professional investment management as discharge their duty of care. As long as the appointment of fund managers is not procedurally impeached, investors are limited in what they can call trustees to account. However, they may indeed take comfort from the employment of professionalism in investment advice and management, even if this means that the structuring of investment management may become more complex, and investors have less direct relationships with investment management services providers. Matters of investment management are not within the ambit of the investor-fund relationship, and can only be raised by the fund entity against the manager.⁸⁸

The lack of standing of the ultimate investor is an issue that arose in recent litigation commenced by ultimate investors against their fund and depositary for having invested in the fraudulent Madoff hedge fund. The court in Dublin, however, rejected that ultimate investors had standing to sue as the investment chain has constructed key private law relationships between nominees and funds and their service providers. Hence beneficiaries/ultimate investors had no direct relationship with funds or service providers to commence legal proceedings. This case reflects the trade-off between direct legal accountability and accessible, professionalised investment management services for ultimate investors.⁸⁹

The Kay Review is also critical about the structure and complexity of investment chains, citing their disengagement from the ultimate investors as a matter of concern, as such disengagement is observed to entail decline of trust and misalignment of incentives.⁹⁰ The survey carried out by the UK's Department of Business, Innovation and Skills in 2016 also suggests that the value added by various layers in the investment chain is uncertain, and the multiplication of complexity and opacity results in investor disengagement from the investment process, thus affecting their ability to call investment intermediaries to account.⁹¹ Judge⁹² rightly argues that the fund management industry is keenly incentivised to create layers and complexity in the investment chain as each layer generates transaction fees and is an extremely profitable practice for intermediaries. Nevertheless, the specialisation of each layer can hardly be faulted in terms of increasing professionalisation of the industry.

investors across funds and making access to investment management possible for a wider range of savers. See, further, Morley, n 83 above.

⁸⁵ Based on the general law of professional negligence, see Spangler, n 61 above, at paras 4.18-4.25; van Setten, n 61 above, at paras 3.51-3.59.

⁸⁶ Spangler, *ibid*, at para 4.26-4.45; van Setten, *ibid*, at paras 3.60-3.69.

⁸⁷ Pensions Act 1995, s 33.

⁸⁸ The latter may not be a realistic prospect if the fund manager and the fund are related, i.e. that the fund is constituted by the management company to begin with. If the manager is an outsource, there may be more realistic prospects of discipline by the fund, but this depends on the terms of the management mandate.

⁸⁹ *Alico Life International Ltd ("Alico") v Thema International Fund plc ("Thema") and HSBC Institutional Trusts Services (Ireland) Limited ("HSBC") and Shmuel Harlap v Thema and HSBC* [2016] IEHC 363.

⁹⁰ Kay Review, n 7 above, at paras 3.9, 3.10, 4.10, 4.12.

⁹¹ BIS, *Exploring the Intermediated Shareholding Model* (January 2016), at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/489357/bis-16-20-intermediated-shareholding-model.pdf.

⁹² K. Judge, 'Intermediary Influence' (2015) 82 *University of Chicago Law Review* 573.

The structural phenomenon of the investment chain creates a diffuse relational web that limits investors' monitoring and recourse. Investors can only look to the fund entity, which, however, does not carry out investment management and does not exercise any corporate governance rights. The fund manager exercises its discretion as accountable to the collective fund entity as a whole, of which any investor's contribution is only a fraction. The investment chain results in a 'separation of ownership from ownership',⁹³ a phrase which aptly describes how savers no longer have sense of direct ownership of the entities they invest in. This channel of ownership is now interposed by the fund manager who acts as manager for the collective investment fund, of which the saver's capital is only a part. Modern investment management structures ultimately disempower investors from being connected from essential aspects of investment management such as corporate governance roles.

To address this governance deficit McGaughey contends that the lack of investors' direct participation rights in corporate governance must be redressed.⁹⁴ However, the pros and cons of the structure of investment management discussed above make this a matter that is far from simplistic. The social/public interest that savers may have in an optimal corporate wealth-creating sector may be lost in translation in the structures of modern investment management, and institutions substitute their own interests in exercising corporate governance rights and powers, no longer reflecting the public and social interest in those roles.

III. Company Law and Corporate Governance – Limitations in Governing Institutional Shareholders' Behaviour

The governance position of shareholders in UK companies is framed by a mix of legislative mandatory rules, 'permissive'⁹⁵ rules, and self-regulatory/soft law rules.⁹⁶ UK company law and soft corporate governance norms (mainly the UK Corporate Governance Code and its predecessors) have been about how to impose mechanisms of governance and accountability on directors and how to ensure that they pursue the interests of shareholders and not themselves underscoring the private agency-based corporate governance paradigm.⁹⁷ In this

⁹³ See L. E. Strine, 'Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance' (2007-8) 33 *Journal of Corporation Law* 1; Conference Board, 'The Separation of Ownership from Ownership' (2013) at https://www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V5N22-131.pdf&type=subsite.

⁹⁴ E. McGaughey, 'Participation in Corporate Governance' (2014) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2593904 (arguing that these investors' inability to exercise corporate governance rights directly is an unjustified separation of contribution and participation).

⁹⁵ These are either 'enabling' such as the system of limited liability, or default, such as section 18 of the Companies Act 2006 which deals with the articles of association. On private ordering see further, B. R. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford: Clarendon Press, 1997), 250-256.

⁹⁶ On the development of soft law and private ordering in corporate governance, see G. P. Calliess and P. Zumbansen, *Rough Consensus and Running Code: A Theory of Transnational Private Law* (Oxford and Portland, Oregon: Hart Publishing, 2012), chapter 4.

⁹⁷ See, for instance, s 172 CA 2006. The only exception to this deliberate policy choice in favour of stakeholders rather than shareholders was during the post-war administration by the Labour Party which promoted the development of the 'social corporation' which should take proper account of the interests of all engaged persons and not simply privilege shareholders. See L.E. Talbot, *Critical Company Law* (Oxford: Routledge-Cavendish, 2008), 112-124.

part, we argue that this preponderant focus in company law and corporate governance rules introduces certain assumptions about the shareholders' role and conduct which do not necessarily hold for institutional investors. Further, we argue that the soft law of stewardship cannot effectively entangle the public interests with investment practices. Consequently, the current legal framework creates certain governance deficits in relation to the institutions' assumption of their shareholder roles.

UK Company Law's Focus on Shareholder Powers on the basis of the 'Shareholders as Monitors' View

UK company law has traditionally emphasised directors' *duties* and shareholder *powers/rights* in the division between the two main organs of the company. This reflects the centralisation of power and authority in the board of directors,⁹⁸ and is widely perceived as an efficient organisational arrangement,⁹⁹ but gives rise to the well-discussed agency problems.¹⁰⁰ The efficiency narrative has become a major support for framing shareholders' rights and powers as being proprietary in nature,¹⁰¹ in order to proportionately address the agency problem presented and establish shareholders as monitors of management.

Much in alignment with the agency theory, UK company law reserves a wide range of powers to shareholders (including voting rights and the right to remove directors without cause),¹⁰² and promotes their participatory roles for the purposes of constructive monitoring and controlling of managerial discretion. Further, to hold directors accountable for their failures, great emphasis was placed on directors' duties, developed in case law from the turn of the twentieth century¹⁰³ and subsequently codified in the Companies Act 2006.¹⁰⁴ Unlike directors who owe duties to the company under company law, shareholders are regarded as not subject to any fiduciary¹⁰⁵ duties to the company, or to fellow shareholders.¹⁰⁶ As the board of directors is the most important decision-making body and the general meeting only

⁹⁸ For the default division of powers between board and shareholders see Art 3 of the Model Articles for Public Companies and relevant case law, such as *Quin & Axtens v Salmon* [1909] A.C. 442, HL.

⁹⁹ See, among others, A. A. Alchian and H. Demsetz, 'Production, Information Costs, and Economic Organization' (1972) *The American Economic Review* 777; O. Williamson, 'Corporate Governance' (1984) 93 *Yale Law Journal* 1197; M. Blair and L. Stout, 'A Team Production Theory of Corporate Law' (1994) 85 *Virginia Law Review* 657; S. M. Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2002) 97 *Northwestern University Law Review* 547.

¹⁰⁰ See Jensen and Meckling, n 25 above.

¹⁰¹ The proprietisation of shareholder rights is advocated in S. J. Grossman and O. D. Hart, 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration' (1986) 94 *Journal of Political Economy* 691. See also Alchian and Demsetz, n 101 above (on the residual claimant theory).

¹⁰² Companies Act 2006, ss 188ff, s 168. In addition shareholders in the UK enjoy several procedural rights in relation to general meeting, including the right to initiate a meeting, to add an item on the agenda and the right to circulate a statement. See Companies Act ss 314-6 and 338.

¹⁰³ See, for example, *Percival v Wright* [1902] 2 Ch 421 stating in no uncertain terms that directors' fiduciary duties are owed to the company; *Cook v Deeks* (PC) [1916] 1 AC 554 indicting directors for self-dealing.

¹⁰⁴ Companies Act, ss 170-182.

¹⁰⁵ On the nature of the fiduciary duty, see M. Conaglen, 'The Nature and Function of Fiduciary Loyalty' (2005) 121 *Law Quarterly Review* 453; R. Flannigan, 'The Economics of Fiduciary Accountability' (2007) 32 *Delaware Journal of Corporate Law* 393.

¹⁰⁶ This is in marked contrast with the US legal regime, which imposes fiduciary duties on majority controlling shareholders and in closely held private companies. See P. J. Dalley, 'The Misguided Doctrine of Stockholder Fiduciary Duties' (2004) 33 *Hofstra Law Review* 175; J. Dammann, 'The Controlling Shareholder's General Duty of Care: A Dogma That Should Be Abandoned' (2015) *University Illinois Law Review* 479.

enjoys reserve powers,¹⁰⁷ the notion of duties to be developed for shareholders towards the company has seemed unnecessary.¹⁰⁸ Nevertheless, opportunities did arise in case law to consider how the exercise of shareholder powers should be subject to some qualifications. In particular, English case law highlighted some concerns regarding shareholders' the right to vote freely on constitutional amendments, and qualified this right to be subject to the interests of the company as a whole,¹⁰⁹ and also to refrain from minority shareholder oppression.¹¹⁰ These qualifications reflect attempts to strike a balance between deference towards the quasi-proprietary nature of the right to vote,¹¹¹ and concerns that shareholder power should not be totally unbridled. However, incremental developments in case law never gave rise to a coherent framework for the governance of shareholders' control powers, as the narrative merely shifted to issues relating to the protection of minority shareholders.¹¹²

The 'shareholders as monitors' view which supports strong participatory rights but almost no duties has been reinforced following the global financial crisis 2007-9, which saw the near-failure of a number of important British banks. One of the policy findings in post-crisis diagnosis is that institutions should play a greater role in corporate governance in order to monitor management that may drive companies into corporate failure.¹¹³ The Walker Review was specifically tasked to look into corporate governance in certain failed financial institutions during the financial crisis.¹¹⁴ The Review concluded that shareholders ought to monitor and be supported in such positions in order to call management to account. The UK subsequently introduced a suite of legislative reforms to enhance shareholder engagement.

Perhaps most importantly, a mandatory shareholder vote on the remuneration policy at the shareholders' annual general meeting was introduced in 2013, in addition to an advisory vote on implementation.¹¹⁵ The UK was the forerunner in mandating public companies to allow shareholders an advisory vote on the annual remuneration report in 2002,¹¹⁶ which became compulsory in 2013. The new regime aims to give shareholders more leverage on executive pay, as the companies are only permitted to pay remuneration to their directors in line with a remuneration policy that has been previously approved at the general meeting. Advocates of say on pay contend that strengthening the shareholders' role in the setting of managerial compensation promotes a stronger link between pay and performance and increases the

¹⁰⁷ See the line of case law on the need for a special majority to exercise reserve power, *Quin & Axtens Ltd v Salmon* [1909] AC 442; *Marshall's Valve Gear Co Ltd v Manning Wardle & Co Ltd* [1909] 1 Ch 267. See also Model Articles for Private Companies Limited by Shares, Art 4.

¹⁰⁸ However, liability can be imposed on shareholders qua director or qua officer. See *Cook v Deeks* (PC) [1916] 1 AC 554.

¹⁰⁹ *Allen v Gold Reefs of W. Africa Ltd* [1900] 1 Ch 656; *Brown v. British Abrasive Wheel Co* [1919] 1 Ch 290; *Dafen Tinsplate Co Ltd. v Llanelli Steel Co* [1920] 2 Ch 124.

¹¹⁰ *Arbuthnott v Bonnyman & 18 Ors* [2015] EWCA Civ 536.

Northern Counties Securities Ltd v Jackson & Steeples Ltd [1974] 1 WLR 1133.

¹¹² Such as the minority oppression remedy under Companies Act 1948, s 210 that was later reformed to be the unfair prejudice petition remedy under Companies Act 1985, s 459 and Companies Act 2006, s 994.

¹¹³ R. Tomasic and F. Akinbami (2011) 'Towards a new corporate governance after the global financial crisis' *International Company & Commercial Law Review* 237.

¹¹⁴ Walker Review, n 8 above.

¹¹⁵ Companies Act 2006, ss 226B, 226C, 439 and 439A. On the impact of UK corporate governance reforms on executive rewards, see S. Thompsen, 'Executive pay and corporate governance reform in the UK: what has been achieved?' in R. S. Thomas and J. G. Hill (eds.), *Research Handbook on Executive Pay* (Cheltenham, UK: Edward Elgar Publishing, 2015), 58.

¹¹⁶ The Directors' Remuneration Report Regulations 2002, SI 2002/1986.

accountability of corporate directors to shareholders.¹¹⁷ In addition, they anticipate that shareholders, and especially institutional investors, will actively participate in the setting of executive pay demanding changes that better align directors' remuneration with the long-term interests and sustainability of the company.¹¹⁸

Further, corporate transparency was reformed post-crisis to provide shareholders with more meaningful information. The key legislative reform introduced was the overhaul of directors' annual reporting and the introduction of the Strategic Report in 2013.¹¹⁹ The Strategic Report is a move towards enhanced narrative reporting which sets financial reporting in context so that shareholders can engage with companies bearing in mind their unique strategic and operating contexts. Narrative reporting is seen as a way to encourage intelligent and 'tailor-made' shareholder engagement.¹²⁰ Further, the Financial Reporting Council has also issued guidelines on directors' business and financial reporting that directors should include a longer-term viability statement in the Strategic Report in order to advise shareholders of any longer term risks and outlooks that may affect the viability of the company in a period exceeding twelve months.¹²¹ With increased mandatory transparency, the information environment for shareholders has been improved and it is arguably reasonable to expect more engagement and monitoring on the part of institutional shareholders.

In addition to empowering shareholders under company law, policy-makers supported soft law reforms that reinforce shareholder empowerment via the Financial Reporting Council's adoption of the Institutional Shareholder Committee's skeletal Code of conduct in relation to shareholder engagement. The Code has been rebranded into a 'Stewardship' code, framing shareholder engagement into an exercise of responsible ownership which connects the private interests of institutions to their perceived socially important role.

The UK Stewardship Code: A First but Inadequate Step to Address the Public Interests in the Governance Role of Institutions

¹¹⁷ See, for example, *Empowering Shareholders on Executive Compensation: Hearing on H.R. 1257 Before the Committee on Financial Services*, 110th Congress 68 (2007) (written testimony of L. A. Bebachuk, W. J. Friedman and A. Townsend Friedman), at <http://www.gpo.gov/fdsys/pkg/CHRG-110hhrg35402/pdf/CHRG-110hhrg35402.pdf>.

¹¹⁸ For some early findings doubting that shareholder scrutiny on pay is effective, see C. Gerner-Buerle and T. Kirschmaier, 'Say on Pay: Do Shareholders Care?' (2016), at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2720481.

¹¹⁹ Companies Act 2006, ss 414A and 414C.

¹²⁰ Discussed in I. H-Y Chiu, 'Reviving Shareholder Stewardship: Critically Examining the Impact of Corporate Transparency Reforms in the UK' (2014) 38 *Delaware Journal of Corporate Law* 983.

¹²¹ FRC, *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* (Sep 2014), at <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and-Related-Financial-and-Business-Reporting>. This initiative was in response to the critique levied by institutions in the wake of the global financial crisis that going-concern statements of certain banks before the onset of the crisis were not accurate. The state of the going-concern certification was the subject of the Sharman Inquiry who advocated that the concept of 'going concern' did have to be clarified, and that shareholders needed more context-rich information in which to thoroughly assess companies' future prospects. See The Sharman Inquiry, *Going Concern and Liquidity Risks: Lessons for Companies and Auditors, Final Report and Recommendations of the Panel of Inquiry* (June 2012), at <http://www.frc.org.uk/getattachment/591a5e2a-35d7-4470-a46c-30c0d8ca2a14/Sharman-Inquiry-Final-Report.aspx>; and the FRC's feedback statement, at <https://www.frc.org.uk/Our-Work/Headline-projects/The-Sharman-Inquiry.aspx>.

While many of the provisions of the UK Corporate Governance Code are likely to enhance the shareholder status of institutional investors in public companies as they provide an effective channel of communication between institutional shareholders and boards,¹²² the UK Stewardship Code represents the most detailed attempt to date in the UK to address the relationships of institutions and asset managers with their investee companies. The Stewardship Code contains seven main Principles and is enforced on a ‘comply or explain’ basis.¹²³ ‘Stewardship’, in the language of the Stewardship Code, ‘is more than just voting’.¹²⁴ It also includes ‘monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration’ through voting and the development of a ‘purposeful dialogue’.¹²⁵

On the one hand, building on the traditional agency paradigm of corporate governance¹²⁶ the Stewardship Code encourages institutional engagement as a valuable check on managerial abuses and legitimates the acceptable forms of shareholder activism which would be treated as ‘stewardship’. These include both formal exercise of shareholder rights and informal engagement outside of the general meeting context (Principle 4), including collective engagement on the part of institutions (Principle 5). The informal powers that shareholders can exercise through ‘voice’ are now articulated ever more clearly in the Stewardship Code, but it could also be said that the Code sets out the expectations of ‘proper’ shareholder behaviour. In this way, the form of contemporary shareholder activism carried out by hedge funds (including wolf-packs), which is regarded with some scepticism in the UK and Continental Europe, may have to conform to the standards found in the Code.

On the other hand, as we discuss above the Stewardship Code embodies the aspiration of governance that UK policy makers hope to impress upon institutions following the financial crisis. The notion of stewardship, following on from the Walker and Kay Reviews, emphasises on long-termism and the wider public interests associated with investor-led governance. The Stewardship Code encourages asset managers and owners to be cognisant of the public interest in their role, and therefore to move away from a monolithic emphasis on the ‘shareholder as monitor’ view associated with the private agency-based corporate governance paradigm. Stewardship is therefore, viewed as antidote to short-termism. For instance, the reference to wider economic stress under Principle 5 which encourages collective action among institutional investors seems to have the effect of disavowing collective engagement in the interests of private, value-centred objectives and framing shareholder engagement within normative expectations that are consistent with wider public interests.¹²⁷ Also, Principles 1, 2, 6 and 7 of the Stewardship Code dealing with the public disclosure of and periodic reporting on stewardship and voting policies do not merely target the institutions’ beneficiaries. Rather, public disclosure and reporting serve wider interests and enable the public to scrutinise the stewardship activities of institutions and assess their

¹²² For instance, boards with substantial independent director representation are preferred by institutional investors. See J.A. McCahery, Z. Sautner and L.T. Starks (2016) ‘Behind the Scenes: The Corporate Governance Preferences of Institutional Investors’ *Journal of Finance* _

¹²³ See generally J. G. Parkinson and G. Kelly, ‘The Combined Code of Corporate Governance’ (1999) *The Political Quarterly* 101.

¹²⁴ UK Stewardship Code, p 1.

¹²⁵ *Ibid.*

¹²⁶ *Ibid.*

¹²⁷ M. Andenas and I. Chiu *The Foundations and Future of Financial Regulation: Governance for Responsibility* (London and New York: Routledge, 2014).

governance role. The UK Stewardship Code is, in our view, the first attempt to align private and public interests and correct the governance deficits that alienate institutions' corporate governance roles from wider public interests.

However, the effectiveness of the Stewardship Code to address these governance deficits is questionable. First, it is doubtful that the public interest of long-termism aspired by the Stewardship Code and the private interests of institutional investors are always coterminous. For some, institutional investors cannot act as a monitoring force that will moderate excessive risk-taking. For instance, Bebchuk, Cohen and Spamann¹²⁸ argue that shareholder short-termism acted as real pressures for their investee banks before the global financial crisis of 2007-9 and was at least complicit in excessive risk-taking by banks that later failed during the crisis.¹²⁹ Others remain sceptical as to whether shareholder behaviour can indeed be moderated into socially optimal forms as envisaged in the Stewardship Code. For example, Talbot argues that shareholders are inherently unable to fulfil the role of injecting long-termism into corporate culture and stewardship, and hence empowering them through 'stewardship' and more engagement is futile and would only fuel short-termism.¹³⁰ Further, Cheffins opined that the national character of the Code is unlikely to appeal to foreign investors who own the bulk of UK corporate equity and thus the Code is unlikely to foster investor-led governance.¹³¹

In our view, the Stewardship Code is ideologically perplexed. Even though the Code conceptualises investor-led governance within a public-interest framing and is not merely a reiteration of private agency-based concept of institutions as monitors, it continues to make overly optimistic assumptions about the motivations of different types of institutions and their alignment with socially beneficial effects in the long-term,¹³² and there is a lack of critically examining shareholder behaviour and distilling a balanced slate of pros and cons to consider for appropriate governance.¹³³ The Code's rhetorical and ambiguous premises are more likely to pander to institutions' private interests, while doing little to effectively call them to public account in the process of bolstering their powers.

On the practical front, it is also questionable whether asset managers to whom the Code is primarily addressed will be willing to step into the governance role aspired by the notion of stewardship. The fierce competition between asset managers on the basis of relative performance arguably creates little incentives to improve the long-term value of investee companies and promote wider public interests. This is evident in the decreasing numbers of Code's signatories in the last two years and the shift of the FRC's attention from the quantity to the quality of signatories. The FRC introduced in November 2016 public tiering of signatories to the Code in an attempt to improve the quality of reporting against the principles

¹²⁸ L. Bebchuk, A. Cohen and H. Spamann, 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008' (2010) 27 *Yale Journal on Regulation and Public Policy* 257.

¹²⁹ But see P. Davies, 'Shareholders in the United Kingdom' in J. G. Hill and R. S. Thomas (eds.), *Research Handbook on Shareholder Power* (Cheltenham, UK: Edward Elgar, 2015).

¹³⁰ L. E. Talbot, 'Why Shareholders Shouldn't Vote: A Marxist-progressive Critique of Shareholder Empowerment' (2013) 76 *Modern Law Review* 791.

¹³¹ B. R. Cheffins, 'The Stewardship Code's Achilles Heel' (2010) 73 *Modern Law Review* 1004.

¹³² See also I.H.Y. Chiu, 'Turning Institutional Investors into "Stewards"- Exploring the Meaning and Objectives of "Stewardship"' (2013) *Current Legal Problems* 1; S. C. Y. Wong, 'Is Institutional Investor Stewardship Still Elusive?' (2015) *Butterworths Journal of Banking and Financial Law* 508; A. Reisberg, 'The UK Stewardship Code: On a road to Nowhere' (2015) 15 *Journal of Corporate Law Studies* 217.

¹³³ This is extensively examined in Barker and Chiu, n 20 above.

of the Code and create a market incentive in support of engagement.¹³⁴ It is hoped that this will help asset owners to judge how well their fund manager is delivering on their commitments under the Stewardship Code, help those who value engagement to choose the right asset managers and in consequence create a ‘stewardship market’ for asset managers,¹³⁵ but it is still too early to judge on the efficiency of this public tiering exercise. Further, some proxy advisers continue to take a rigid box-ticking approach and pay insufficient attention to comply or explain. This could have a knock-on effect on the quality of stewardship activities undertaken by asset managers as the latter often outsource voting to proxy advisers.

Another weakness of the Code is the fuzziness as to whom institutions are accountable as stewards.¹³⁶ If accountability is to the institutions’ beneficiaries the Code does not add anything to the trusteeship duties already involved. And, we have explained above that beneficiaries are too indifferent and dispersed to hold institutions to account for their stewardship obligations. However, if institutions’ accountability as stewards means something more, as we would expect on the basis of the public interest embodied in the Code, it remains unclear to whom institutions are accountable. And, the exclusion of stakeholders from the stewardship spectrum¹³⁷ suggests that too much deference is still paid to the private agency paradigm of corporate governance in the discharge of the responsibilities of institutional shareholders as owners.

Finally, the Code, being soft law,¹³⁸ does not provide adequately for the accountability and governance mechanisms that would check and balance shareholders’ enhanced engagement roles and powers. Indeed, as the FRC has found,¹³⁹ soft law approaches intending to bring about incremental effects produce very slow results. More fundamentally, soft law approaches, bound in private paradigms of shareholder accountability,¹⁴⁰ could undermine the public interest aspirations of the Stewardship Code and are unable to change investment management at heart. Even though the soft law of stewardship challenges the monolithic shareholder-as-monitor view underpinning much of the UK company law and attempts to conflate the public interests in investor-led governance with the private paradigm of corporate governance, it is too weak to ensure a concomitant governance and accountability for institutions for the wider public. We argue, therefore, that the public interest underlying the notion of stewardship obligations for institutions can find more overt articulation in the securities and investment regulation, to which we now turn.

¹³⁴ <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx>

¹³⁵ See Katelouzou, n 59 above.

¹³⁶ Andenas and Chiu, n 130 above.

¹³⁷ See K. Sergakis (2013) ‘The UK Stewardship Code: Bridging the Gap Between Companies and Institutional Investors’ 47 *Revue juridique Thémis de l’Université de Montréal* 109.

¹³⁸ For instance, Black argues that principles-based regulation can only work in a ‘utopian relational paradigm between the regulator and regulated’ and it is therefore questionable whether they can meet both the institutional and the public interest needs in the real world. See J. Black (2008) ‘Forms and Paradoxes of Principles-Based Regulation’ 3 *Capital Markets Law Journal* 425.

¹³⁹ FRC, *Developments in Corporate Governance and Stewardship 2015* (2016) at [https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-\(1\).pdf](https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-(1).pdf).

¹⁴⁰ M. T. Moore, “‘Whispering Sweet Nothings’: The Limitations of Informal Conformance in UK Corporate Governance’ (2009) 9 *Journal of Corporate Law Studies* 95.

IV. Making a Case for Governing Institutional Shareholders' Conduct in Investee Companies under Securities and Investment Regulation

We have shown so far that the assumption of corporate governance roles by institutions has become disengaged from savers due to the interposition of collective investment structures and the growth of the investment chain. Savers are generally disinterested and are unlikely to be able to exert strong governance powers over fund managers' assumption of corporate governance roles. Further, company law and corporate governance standards do not take into account the institutional shareholders' unique positions and their hitherto pro-shareholder stance is incompatible with the public interest in the impact of institutions' corporate governance roles upon long-term wealth creation by the corporate sector. Institutional shareholders are not 'fiduciary capitalists'¹⁴¹ representing savers' interests and their own interests dominate in their shareholding capacity, profoundly affecting their corporate governance roles. This is a development that is not taken into account of in the private paradigm of company law; company law has not developed maturing notions of shareholder duties and recent policy reforms have focused on shareholder empowerment without due consideration of how shareholder empowerment should be made accountable or governed. We are also of the view that the soft law of the Stewardship Code, despite its public-interest framing, is not either clear or adequate in articulating a framework for articulating institutions' accountability. Merely asking institutions to report to their beneficiaries is not constructive given the distance and limits on the part of beneficiaries to monitor their fund managers.

In this part we suggest that in order to take into account of the wider stakeholder and socio-economic ramifications of institutions' corporate governance roles, there is a public interest case for subjecting institutions' corporate governance roles to regulatory standards and monitoring. The private law frameworks discussed above do not adequately address the wider public interests associated with investor-led governance and how this impact the corporate sector's long-term wealth creation to deliver the expectations of savers who are now enrolled into the financialised system of private saving via collective investment. Indeed, the private law frameworks are even increasingly inadequate to serve their original purposes in ensuring accountability within a trust context and in relation to the division of powers in a company.

Regulators are not agnostic to the long-term socio-economic impact of investment management and in recent years there has been an increasing regulatory attention to ensuring that investment management is an area properly governed. Prudential regulation has been introduced for defined benefit pension schemes for some time now,¹⁴² and although the development of defined contribution schemes removes the financial pressures that apply to defined benefit schemes, regulatory governance has been introduced for defined contribution

¹⁴¹ M. Useem, *Investor Capitalism: How Money Managers are Rewriting the Rules of Corporate America* (New York: Basic Books, 1999); J. P. Hawley and A. T. Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (Philadelphia: University of Pennsylvania Press, 2000).

¹⁴² See, for example, s 226 Pensions Act 1995 under which an annual regulatory obligation is placed on pension funds to carry out actuarial valuations in order to ensure that they meet a 'statutory funding' requirement which assures that they are on track to meet their long-term liabilities.

schemes in terms of its scheme governance¹⁴³ and oversight, as well as fair management fees.¹⁴⁴ EU legislation, transposed into UK law, has extended prudential regulation to retail investment funds that are open-ended,¹⁴⁵ and to alternative investment funds.¹⁴⁶ Further, EU-derived regulation has introduced standardised duties for investor protection,¹⁴⁷ and transposed in the UK, such regulation has boosted investor accountability and enforcement via regular reporting.¹⁴⁸ Regulation has focused on investor protection in the institution-beneficiary relationship and has to date not addressed the public interest concern underlying the financialisation of savings which is mediated through institutions.

The regulation of institutions' corporate governance role is timely and is consistent with the ethos in securities regulation and investment conduct regulation. We propose a blueprint below; we first suggest that institutions should be regulated in terms of disclosing their corporate governance intentions and roles appropriately to the market, so that these roles are not used instrumentally to create unfairness in securities markets. Second, institutions should be governed under investment regulation in terms of their conduct of investment management

¹⁴³ See DWP, *Better Workplace Pensions: Further Measures for Savers* (March 2014), which introduces employee oversight of workplace defined contribution schemes to ensure that the schemes appoint desirable asset managers, are properly managed and overseen and provide value for money. Such oversight is carried out by 'Independence Governance Committees' for the schemes.

¹⁴⁴ See FCA, *Charges in Workplace Personal Pension Schemes: A Consultation Paper* (Oct 2014) and *Final rules for Charges in Workplace Personal Pension Schemes and Feedback on CP14/24* (March 2015) on the charge cap of 0.75% of assets under management, excluding transaction costs.

¹⁴⁵ See Art 7, Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) (UCITs Directive 2009), under which EU-wide approved mutual funds known as UCITs are to have an initial capital at 125,000 euros and own funds at 0.02% of assets under management. This is transposed in the UK FCA Handbook, IPRU-INV chapter 5.

¹⁴⁶ See Art 9, Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (AIFMD 2011), under which hedge and private equity funds that are internally managed must have an initial capital of 300,000 euros, or if externally managed, to have an initial capital of 125,000 euros. Funds are to maintain 0.02% of assets under management exceeding 250 million euros as own funds. This is transposed in the UK FCA Handbook, IPRU-INV, chapter 11.

¹⁴⁷ See Arts 13, 17-18, 20-23, Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company. These relate to management of conflicts of interest, duties of diligence in management, treating investors fairly and acting in their best interests, and considering using the rights to vote in investee companies, and were transposed in the UK via The Undertakings for Collective Investment in Transferable Securities Regulations 2011, SI 2011/1613.

See also Art 12, Directive 2011/61/EU of the European parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, which imposes on fund managers direct duties to investors in conduct of business. Specifically, Article 12 provides for investor protection duties on care, skill and diligence, to employ resources effectively for the performance of due functions, to manage conflicts of interest, to act in the best interests of investors, to comply with all regulatory requirements and to treat investors fairly. This was transposed into UK law via the Alternative Investment Fund Managers Regulations 2013 (SI 2013/1773).

¹⁴⁸ Regular reporting is mandated under the UCITs Directive 2009, for example Arts 68, 69, 73, and the AIFMD 2011, Arts 22-23, for investors in terms of annual and periodic reporting, and specific reporting to regulators. see Art 24, and Arts 110-111, Commission Delegated Regulation (EU) No 231/2013 of 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012). These are transposed in the FCA Handbook, COLL 4 and FUND 3.

in order to achieve adequate investor protection and to mitigate the externalities of short-termism discussed earlier.

A Case for Governing Institutions' Shareholder Roles in Securities Regulation

At first blush, regulating institutional shareholders as a matter of securities regulation looks contrary to the erstwhile approach in securities regulation that imposes duties on publicly traded companies *vis a vis* their investors. Securities regulation is chiefly premised on investor protection, seeking not only to promote efficient capital markets but also fair markets in which investors have confidence. The broad categories of duties in securities regulation are mandatory disclosure to primary markets,¹⁴⁹ mandatory continuing disclosure to secondary markets,¹⁵⁰ corporate governance obligations that secure minority shareholder protection¹⁵¹ and other duties imposed on non-issuer constituents that may affect investors (such as disclosure duties on analysts¹⁵² and underwriters).¹⁵³

Mandatory disclosure is often justified to ensure that optimal amounts of accurate information are released in order to foster an efficient securities market,¹⁵⁴ in which the market prices efficiently reflect all information underlying the securities at any given time. Price efficiency promotes fairness and certainty, and supports investor participation in the markets. Even if we may not fully subscribe to the efficient capital markets hypothesis¹⁵⁵ and the model of the information-hungry rational investor,¹⁵⁶ the duty to be transparent via public disclosures achieves the additional benefit of securing accountability on the part of corporate

¹⁴⁹ Governed by the Council Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading [2003] OJ L345/64 (the Prospectus Directive) as amended by Council Directives 2008/11/EC, 2010/73/EU, 2010/78/EU, 2013/50/EU, and 2014/51/EU and UK Prospectus Regulations 2005 and Listing Rules under the FCA Handbook.

¹⁵⁰ Governed by the Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market as amended by Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013, OJ L 294 (Transparency Directive), Council Directive 2003/6, on Insider Dealing and Market Manipulation (Market Abuse), 2003 OJ (L 96) 16; transposed in FCA Handbook DTR.

¹⁵¹ In the UK, the Corporate Governance Code is incorporated into the Listing Rules for Premium Listed companies, subject to a comply or explain approach. See Listing Rules 6.1.4ff for minority shareholder protection in the governance arrangements between a controlling shareholder and the company.

¹⁵² See, for example, the US Sarbanes-Oxley Act 2002, s 501 requiring analysts to make disclosure of their conflicts of interest in making equity recommendations. This is governed to a similar extent in the EU Markets in Financial Instruments Directives 2004, 2014 that seeks to ensure the independence of analyst research; FCA Handbook COBS 12.

¹⁵³ For example, underwriter duties are imposed under the Commission rules pursuant to the EU Markets in Financial Instruments Directive 2014 to ensure that underwriters treat issuers fairly.

¹⁵⁴ J. C. Coffee Jr, 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717; M. B. Fox, 'Rethinking Disclosure Liability in the Modern Era' (1997) 75 *Washington University Law Quarterly* 903; J. D. Seligman, 'The Historical Need for a Mandatory Corporate Disclosure System' (1983) 9 *Journal of Corporation Law* 1.

¹⁵⁵ R. J. Gilson and R. H. Kraakman, 'Mechanisms of Market Efficiency' (1984) *Virginia Law Review* 549; M. Kahan, 'Securities Law and the Social Costs of "Inaccurate" Stock Prices' (1991) *Duke Law Journal* 977. See, however, J. N. Gordon and L. A. Kornhauser, 'Efficient Markets, Costly Information and Securities Research' (1985) 60 *New York University Law Review* 761, (pointing out that the efficient markets hypothesis has been rendered simplistic by later economic theories).

¹⁵⁶ The behavioural writings have put the model of the rational investor in grave doubt; see R. A. Prentice, 'Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future' (2002) 51 *Duke Law Journal* 1397; N. Moloney, *How to Protect Investors* (Cambridge: CUP, 2010), chapters 2, 3; and more recently T. C. W. Lin, 'Reasonable Investors' (2015) 95 *Boston University Law Review* 461.

management,¹⁵⁷ and invites scrutiny into the veracity of disclosures, the quality of governance and the promises of the business in general. Hence, market transparency is an essential tenet of investor protection regulation.

Corporate transparency to the marketplace has always been imposed on companies, but securities regulation also recognises that disclosure *by investors* is becoming increasingly relevant to the information environment of the securities markets. In the UK, an investor acquiring shares in a publicly traded company must inform the issuer and the Listing Authority (the Financial Conduct Authority) of her holdings if she crosses a 3% threshold and every 1% thereafter.¹⁵⁸ Further, EU regulation compels net short sellers in equities to disclose to the relevant regulator short positions from 0.2% of the company's equity onwards with every increase of 0.1%.¹⁵⁹ Where short positions reach 0.5% of the company's equity, public disclosure needs to be made by the net short seller.¹⁶⁰

It may be argued that it is not only investor holdings/interests and identities that may be price-sensitive information in the marketplace, but, as investors are asked and expected to engage with companies,¹⁶¹ engagement agendas and behaviour may also become important signals in the marketplace for other investors.¹⁶² In the US, institutions that acquire 5% or more of a publicly traded company's equity as beneficial owners must disclose the stake and the purpose of the investment.¹⁶³ In the EU, the Transparency Directive is silent on the issue of intentions-related disclosure, but some EU Member States, including France and Germany, impose additional disclosure obligations for large investors in relation to the objectives pursued by their investment.¹⁶⁴ The disclosure of investment objectives is increasingly being viewed as a price-sensitive signal to the market as signals of shareholder activism intentions will likely affect share price. Much empirical research on hedge fund activism points to the share price effects that entail from an announcement of beneficial stakes by activist hedge funds.¹⁶⁵ It may reasonably be argued that the investment value of a company may be perceived by investors to be affected by how other investors relate to it. Hence, increased transparency should be imposed on institutional shareholders, such as in relation to shareholder engagement intentions, plans and outcomes.

Further, securities regulation is keenly concerned with minority shareholder protection, and, in our view, regulatory standards should be introduced to ensure that institutional shareholders' assumption of corporate governance roles does not adversely affect minority shareholder protection objectives. Since the seminal thesis by La Porta et al¹⁶⁶ supporting the

¹⁵⁷ P. G. Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) *University of Chicago Law Review* 1047; D. C. Langevoort, 'Commentary: Stakeholder Values, Disclosure and Materiality' (1998) *Catholic University Law Review* 93.

¹⁵⁸ FCA Listing Rules DTR 5.1, 5.9.

¹⁵⁹ EU Short Selling Regulations 2012, Art. 5.

¹⁶⁰ EU Short Selling Regulations 2012, Art 6.

¹⁶¹ Discussed in relation to the EU Proposed Shareholder Rights Directive below.

¹⁶² Katelouzou, n 59 above, 814-5 (analysing the link between intentions-related disclosure and hedge fund activism).

¹⁶³ Securities Exchange Act 1934, Sched 13D.

¹⁶⁴ Katelouzou, n 48 above, 815.

¹⁶⁵ See, for example, Brav et al, n 50 above.

¹⁶⁶ R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. W. Vishny, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113; R. La Porta, F. Lopez-de-Silanes and A. Shleifer, 'What Works in Securities Laws' (2006) 71 *Journal of Finance* 1. Also see Coffee's views that SEC enforcement is a crucial attractive support to securities markets; J. C. Coffee, 'Law and the Markets – The Impact of Enforcement' (2007) 156 *University of*

important relationship between law and finance, and, in particular, contending that the protection of minority shareholders affects the development of securities markets, practical steps have been taken in many key capital markets jurisdictions¹⁶⁷ to improve minority shareholder protection through securities regulation (such as disclosure regimes) and through the introduction of corporate governance standards¹⁶⁸ for listed companies. These standards are perceived to provide minority shareholders with a sense of protection and assurance in the governance quality of companies listed on those markets.

In our view, minority shareholders are not only concerned about corporate governance standards for Boards.¹⁶⁹ Increasingly, minority shareholders are also concerned about the composition and dynamics of the company's shareholding structure, as these affect the quality of governance. Evidently, minority shareholders are concerned about controlling shareholders, as the fiascos with respect to the previously London-listed ENRC and Bumi have heightened disquiet about controlling shareholders' expropriation of the companies, and negative impacts on company share price.¹⁷⁰ Also, minority shareholders' attention is often paid to the issue of dual-class voting rights due to often disproportionate voting power certain special shareholders enjoy despite low cash flow rights.¹⁷¹ Other minority shareholders'

Pennsylvania Law Review 229. Critiques of law and finance scholarship are sceptical of its broad brush approach and methodological weaknesses; see H. Spamann, 'The "Antidirector Rights Index" Revisited' (2010) 23 *Review of Financial Studies* 467; B. R. Cheffins, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies' (2003) 23 *Oxford Journal of Legal Studies* 1; R. V. Aguilera and C. A. Williams, 'Law and Finance': Inaccurate, Incomplete, and Important' (2009), at <http://ssrn.com/abstract=1523895> (acknowledging, however, that the 'law and finance' connection has fired research imagination fruitfully towards this area).

¹⁶⁷ For example, corporate governance improvements to the Hong Kong listing regime, discussed in R. Barker and I. H-Y Chiu, 'Protecting Minority Shareholders in Blockholder-Controlled Companies – Evaluating the UK's Enhanced Listing Regime in Comparison with Investor Protection Regimes in New York and Hong Kong' (2015) 10 *Capital Markets Law Journal* 98; H. Yeung and F. Xiao Huang, 'Law and Finance: What Matters? Hong Kong as a Test Case' (2012) 3 *Asian Journal of Law and Economics* 1.

¹⁶⁸ L. Zingales, 'The Future of Securities Regulation' (2009) 47 *Journal of Accounting Research* 391. For empirical evidence on the increased valuation of companies on securities markets driven by investor preferences where good corporate governance is instituted, see F. Berton, M. Meoli, and S. Vismara, 'Board Independence, Ownership Structure and the Valuation of IPOs in Continental Europe' (2014) 22 *Corporate Governance* 116; L. D. Brown and M. L. Caylor, 'Corporate Governance and Firm Valuation' (2009) 25 *Journal of Accounting and Public Policy* 409 (arguing that there are only a few cherished corporate governance notions that make a difference eg independent directors); K. H. Chung and H. Zhang, 'Corporate Governance and Institutional Ownership' (2011) 46 *Journal of Financial and Quantitative Analysis* 247; A. Picou and M. J. Rubach, 'Does Good Governance Matter to Institutional Investors? Evidence from the Enactment of Corporate Governance Guidelines' (2006) 65 *Journal of Business Ethics* 55.

¹⁶⁹ Such as in relation to Board composition (eg independent representation, institution of committees or gender diversity), or to executive compensation.

¹⁷⁰ Discussed in Barker and Chiu, n 171 above.

¹⁷¹ For example, Google's founder shareholders Larry Page and Sergey Brin have retained significant control of 55.7% after the initial public offer of shares despite having only 15% of the cash flow rights. They cite their long-term perspective as rationale for supporting the issue of a class of non-voting shares, which controversially started trading in April 2014. For empirical research indicating that dual-class voting structures can reduce trust in companies and may be avoided by some investors, see V. Jog and A. L. Riding, 'Price Effects of Dual-class Shares' (1986) *Financial Analysts Journal* 58. Gompers and others also find that listed companies with dual-class structures have by and large performed worse over the long term than those without a controlling shareholder; see P. A. Gompers, J. Ishii and A. Metrick, 'Extreme Governance: An Analysis of Dual-Class Firms in the United States' (2010) 23 *Review of Financial Studies* 1051; 'The Cost of Control', *The Economist* (21 July 2011). However, successful companies such as Berkshire Hathaway, News Corp, Google, Facebook, Amazon and a host of other internet-based companies such as LinkedIn, Zynga, Groupon and JD.com and

concerns may relate to (a) differences in corporate governance rights between long- and short-term shareholders, such as in relation to the recent French reforms which give long-term investors double voting rights;¹⁷² (b) activist shareholders,¹⁷³ and (c) shareholders whose voting rights are decoupled from economic rights and thus may have perverse incentives in exercising voting rights ('the empty voting' concern).¹⁷⁴

Some of these issues have been recognised and addressed to different extents. For example, the UK Listing Rules have been amended to subject controlling shareholders of Premium-listed companies on the London Stock Exchange to certain governance arrangements with their companies in order to prevent disproportionate exercises of power that adversely affect minority shareholders.¹⁷⁵ Although dual class shares are not prohibited in the UK and certainly feature in many prominent companies listed on the key stock exchanges in New York, they are not without controversy. The French endorsement of greater rights for longer term shareholders is also not without controversy as such a measure can be seen as a means of empowering incumbent (domestic) shareholders against foreign minority investors new to the company.¹⁷⁶ Activist shareholders may also not be regarded as an unequivocal good as different forms of activism exist and some may be disruptive and negatively affect the company.¹⁷⁷ Further, empty voting may pose as a snare to fellow investors, although policy-makers have not found sufficient evidence to warrant regulatory intervention.¹⁷⁸

The above is a survey of the issues relating to institutional shareholder conduct that ought to be studied in framing securities regulation for institutions' corporate governance roles for the purposes of maintaining fair and transparent capital markets. Next, we turn to the case for introducing regulation for institutions' corporate governance roles as a matter of investment management practice.

A Case for Governing Institutions' Shareholder Roles in Investment Management Regulation

We contend that regulatory standards of conduct should be introduced for investment management, in order to account for the effectiveness of investment management over the long-term and the exercise of corporate governance roles as part of that. These standards of conduct may be formulated for different entities in the investment chain discussed earlier in this article. The development of a regulatory regime achieves the 'publicisation' of investment management as a matter of public interest, by articulating standards for optimal

Alibaba.com from China continue to attract investors who wish to share in the upside of successful companies led by talented founders (despite their apparently weak position as minority shareholders).

¹⁷² The Florange Law, discussed in 'Short Term or Short Changed?', *The Economist* (2 May 2015).

¹⁷³ See, for example, A. Dignam, 'The Future of Shareholder Democracy in the Shadow of the Financial Crisis' (2013) 36 *Seattle University Law Review* 639.

¹⁷⁴ See, for example, H. T. C. Hu and B. S. Black (2007) 'Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership' 13 *Journal of Corporate Finance* 343.

¹⁷⁵ The mandatory agreement regime, FCA Listing Rules 6.1.4ff, also see Barker and Chiu, n 171 above.

¹⁷⁶ 'Protectionist French Law Alarms Investors', *Financial Times* (22 Feb 2015).

¹⁷⁷ See 'Activist Hedge Funds Not so Good for Shareholders', *Financial Times* (21 May 2015), and concerns we discussed earlier in the article.

¹⁷⁸ ESMA, *Feedback Statement: Call for Evidence on Empty Voting* (29 June 2012), at <http://www.esma.europa.eu/system/files/2012-415.pdf> accessed 23 April 2016 (highlighting the difficulty in defining the concept, and pinpointing what precise mischiefs are related to empty voting, as well as the general lack of evidence although consultees assert that empty voting occurs in EU markets).

and accountable investment management, and making certain investment management practices a matter for regulatory compliance. Further, there is the possibility of investors mounting civil actions or breach of statutory duty on the back of successful regulatory enforcement.¹⁷⁹

The EU has already introduced legislation that deals with the corporate governance roles of retail collective investment funds. In 2010, the European Commission introduced an initiative to improve investor protection by imposing conduct of business obligations on management companies of UCITS funds.¹⁸⁰ As part of regulating the investment management practices of fund managers, the Directive also imposes a duty on management companies to develop policies on how their voting rights in investee companies should be exercised for the benefit of the funds. Management companies are also to consider how forms of shareholder engagement or activism may be carried out in order to secure the best interests of the funds.¹⁸¹

Further, the governance deficits in the investment chain discussed above have recently attracted the attention of regulators in the UK and EU. In the UK, the Law Commission acknowledges that pension funds use pension consultants to advise them on asset allocation and the appointment of suitable asset managers.¹⁸² As there are only a handful of dominant consultancies in the market, such as Mercer and Towers Watson, and pension funds rely heavily on consultants' advice, the Law Commission suggests that regulatory standards and scrutiny should be extended to them to ensure that principal-agent problems are mitigated and that consistency be maintained with other regulatory regimes for investment.¹⁸³

In the EU, the European Commission is concerned about how asset managers and proxy advisors are relatively unregulated although they wield significant influence in funds' corporate governance positions. The proposed EU Shareholders' Rights Directive¹⁸⁴ contains provisions that subject asset managers and proxy advisors to certain transparency obligations, showing increasing interest in governing their roles and accountability in the investment chain. Articles 3g and 3h of the proposed Directive deals with disclosure by institutions to the public, and by asset managers to their institutional clients, in order to account for how asset managers meet their clients' needs in terms of investment horizon and maturity of liabilities. The European Parliament further suggests amendments to require that a part of asset managers' disclosures be made public, reflecting the public interest their roles.¹⁸⁵ Article 3i

¹⁷⁹ Financial Services and Markets Act 2000, s 50.

¹⁸⁰ Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company. This is implemented largely by the FCA in FCA Handbook COLL, which also dovetails several aspects of NURs with UCITS.

¹⁸¹ Commission Directive 2010, Art 21.

¹⁸² Law Commission, *Fiduciary Duties of Investment Intermediaries* (June 2014) at paras 11.51-11.62.

¹⁸³ *Ibid.*

¹⁸⁴ Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (SWD(2014) 126,127,128 final) published 9 April 2014 (hereinafter 'proposed Shareholder Rights Directive'), Parliament amended version of 8 July 2015 at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P8-TA-2015-0257+0+DOC+XML+V0//EN>.

¹⁸⁵ Disclosure is to be made with particular reference to:

of the proposed Shareholders' Rights Directive imposes a duty on proxy advisory agencies to 'ensure to the best of their ability that their research and voting recommendations are accurate and reliable, based on a thorough analysis of all the information that is available to them, and are developed in the sole interest of their clients'. These agencies are further subject to conduct standards in voluntary codes of conduct where they may be applicable. As proxy advisers play an important role in supporting institutions' voting and hence key decision-making powers at the general meeting of the company, it is regarded as a matter of public interest that proxy advisers' influence over institutions' corporate governance roles be subject to appropriate standards of conduct and public scrutiny. Indeed, the European Commission, in introducing these amendments, explains¹⁸⁶ that improving shareholder engagement is for the purposes of addressing the issue of excessive short termism on the part of the asset management industry in managing institutional funds. The Commission's concerns are rooted in public interest concerns regarding the viability of pension savings through investment, and the proposed provisions are arguably a form of re-regulation.

The developments above show that policy-makers are increasingly supportive of introducing standards for scrutinising investment management practices, their corporate governance roles being seen as a key aspect of their investment management practices. However, the above are rather limited. They are patchwork in nature as they focus on particular aspects of investment management practices without a holistic consideration of the nature of investment management practices as a whole. Further, the proposed European Directive adopts a comply-or-explain approach which is odd given its underlying concern for the public interest in institutions' corporate governance roles and many of its public disclosure and accountability requirements.¹⁸⁷

We support further steps to be taken to develop a comprehensive regulatory regime in the UK for entities in the investment chain, from standard setting to supervisory accountability. We believe that there should be greater regulatory accountability for the objectives in shareholder engagement, and such engagement should be for the long-term well-being of the company taking into account of other shareholders' and stakeholders' interests. Asset managers must also show how their shareholder engagement behaviour is not tainted by conflicts of interest. The roles of investment chain entities also need to be properly accountable for the overall public interest of savers. We are of the view that the securities and financial regulator in the UK, the Financial Conduct Authority is well-placed to regulate institutions' investment management practices, including their shareholder behaviour.

Some Initial Thoughts on Implementing an Effective Model of Regulatory Duties

First, investment funds and their asset managers should explain how their strategies, including the use of corporate governance rights and powers, are aligned with the long-term

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- (a) how investment decisions are made, in terms of considerations of long term corporate performance and non-financial performance;
 - (b) explaining the level of portfolio turnover;
 - (c) the management of actual or potential conflicts of interest in connection with engagement activities;
 - (d) the use or otherwise of proxy advisors for the purpose of engagement activities; and
 - (e) how their investment strategy and implementation contributes to the medium to long-term performance of the assets of the institutional investor.

¹⁸⁶ Proposed Shareholder Rights Directive, at pp 4, 5, 7 and 8.

¹⁸⁷ I. H-Y Chiu and D. Katelouzou, 'From Shareholder Stewardship to Shareholder Duties: Is the Time Ripe?' in Hanne Søndergaard Birkmose et al (eds), *Shareholders' Duties* (Kluwer Law International, 2017 Forthcoming).

interests of savers. Consistent with the proposed EU Shareholders' Rights Directive we believe that such targeted, public interest-oriented reporting from asset managers and asset owners is a necessary first step. The reporting obligations under Articles 3g and 3h of the proposed EU Shareholders' Rights Directive are to the public, and will import of wider scrutiny from regulators. One drawback, however, is that such reporting may be qualitative and difficult to judge, and the regulator may need to develop in time a set of best practices such as non-mechanistic reliance on corporate governance service providers, meaningful and not overly frequent portfolio turnover etc. We believe this area to be under-developed and this paper provides a starting point, which can be further refined in terms of detail.

Next, we consider it necessary to impose standards on service providers in the investment chain to manage conflicts of interest robustly and to adhere to the standard of having the ultimate savers' interests in mind. As entities in the investment chain do not owe private law duties to the ultimate savers', the diffusion of legal duties through investment management structuration has weakened the sense of purpose of saver-focused investment management which is aligned with public interest and social good. Regulatory duties can overcome the lack of appropriate private law duties and accountability, and re-introduce an orientation towards public-interest for all entities in the investment chain. And, we foresee subjecting fund managers, pension consultants, and proxy advisers to such a standard.

We do not necessarily think that forcing funds or asset managers to informally engage or vote, as the UK Stewardship Code envisages is certainly representative of good practice in looking after savers' long-term interests. These actions are symptomatic and procedural, while the substantive good of savers' long-term interests need not be represented in them. An asset manager can actively agitate a company for share buy-backs for example, which could be short-termist in nature and adverse to the company's use of retained earnings in the long-term. Thus, the engagement in visible forms of action says nothing about the substantive good of protecting savers' long-term interests through constructive corporate governance roles in investee companies. Indeed there may be a case to impose a regulatory duty to refrain from short-termist actions that may have adverse long-term impact.

Scepticism of Regulation as an Optimal Governance Solution?

So far, we have set out a case for arguing that investment management practices affecting the institutions' corporate governance role should be regulated as a distinct regime extending from securities regulation and investment management law. However, it may be objected that even if institutions' shareholder roles need to be subject to a form of governance, regulation is not an optimal means to provide such governance.¹⁸⁸

First, one may argue that regulating the corporate governance role of institutions under securities and investment management regulation law takes away the benefits of the self-regulation approach which characterises UK corporate governance. Corporate governance in the UK is largely viewed as an internal matter for companies and the involvement of policy-makers is largely facilitative, shaped by bottom-up influences from the industry itself, rather than prescriptive. Although self-regulation in theory can have advantages in terms of

¹⁸⁸ It is important to note here (and we have seen that already when we examined the UK corporate governance regime earlier in this article) that UK regulation is largely 'decentred' and it is difficult to draw a dichotomy between governmental regulation and self-regulation. For a rich analysis of the increasingly decentring regulation, see J. Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a 'Post-Regulatory' World' (2001) 54 *Current Legal Problems* 103.

flexibility, expertise and cost, compared to regulation by government, none of these are clear-cut.¹⁸⁹ Take, for instance, the Stewardship Code. The Code, being ‘soft’ in nature (but not purely self-regulatory), may help to deliver flexibility via its comply-or-explain approach and open-textured principles. On the other hand, it concomitantly involves insufficient certainty and weak enforcement.¹⁹⁰

Another objection some might raise to our proposal is that regulation is not a panacea for governance deficits. It may be argued that by introducing regulatory standards for investment management, such standards will become a body of obligations for compliance, and will further fail to meet investors’ needs, increasing their disengagement and disempowerment from the investment management process. It cannot be assumed that the regulator is best placed to substitute the essential monitoring that investors need to carry out to ensure that their collective private interests are met in the long term. Regulatory standards may be rigid, over-or under-inclusive, and would be ‘one-size-fits-all’. However, we are of the view that investor disengagement and disempowerment is already a structural problem and regulatory governance can introduce much-needed change instead of waiting for collective saver initiatives to arise. In other words, even if regulatory governance cannot take the place of investors’ own monitoring for their private interests, it performs an imperfect substitutive effect that is superior to the situation of the current lacunae. Further, regulatory enforcement can overcome much of the limitations in enforcement faced by investors in terms of causes of action and the collective action problem. Finally, the introduction of regulatory standards is able to more clearly articulate the objectives of investment management in key categories of savings such as pension schemes that take into account the public interest dimension. We see the potential for regulation to provide clarity for investments based on corporate social responsibility indicators, an area that has been dogged by uncertainties and limitations in private law.¹⁹¹

Finally, it may be argued that regulatory standards are not able to presume what optimal roles in corporate governance institutions should assume. Hence, regulatory standards may be worded broadly and leave much to regulator’s discretion to carry out enforcement, often with the benefit of hindsight. This creates a chilling environment for investment management, a business that is essentially concerned with judgment and risk-taking. Making investment fund managers too risk averse is not in the interests of investors who need a return for their savings over the long term. However, we are of the view that regulatory standards and their enforcement need not create an adversarial relationship between investment managers and regulators. Widely worded regulatory standards are rooted in principles, such as in the 11 principles for investment regulation promulgated by the FCA and its predecessors,¹⁹² and best practices can be forged in more concrete terms as guidelines that can change and be flexible.

¹⁸⁹ For a detailed analysis of the advantages and disadvantages of self-regulation, see Cheffins, n 97 above, chapter 8.

¹⁹⁰ See text to notes 142-4 above.

¹⁹¹ It is to be noted that social responsibility preferences may come from investors or trustees and the issue is not necessarily an issue revolving only around investors feeding their preferences into the fund. It could be an issue of whether trustees are channelling their preferences improperly into fund management. Overall it seems that commentators do not think private law obligations prevent such investment, see B. J. Richardson, *Socially Responsible Investment Law* (New York: OUP, 2008). But such investment cannot be inconsistent with the fund objectives and the ultimate delivery of beneficiaries’ interests, see UNEP Finance Initiative, *A Legal Framework for Integrating Environmental, Social and Governance Issues into Institutional Investment* (2005).

¹⁹² FCA Handbook PRIN module.

The UK regulator had had many years of experience in principles-based regulation and working with the industry to forge interpretive guidance.¹⁹³ In fact, much of the critique against principles-based regulation is based on the regulator's willingness to listen excessively to industry needs and be subject to a form of capture.¹⁹⁴ We suggest that a mixture of rules and principles-based regulation in investment management practices can provide a framework to align investment management practices with public interests.

Conclusion

In this article we make a case for governing the assumption of corporate governance roles by institutional shareholders and their fund managers. We argue that institutional shareholder conduct as an investment management practice raises concerns in relation to its possibly deleterious impact on companies and it is to be queried whether savers' and corporate interests over the long-term are well-served by institutions' shareholder roles, however practised. Private law frameworks for investor-intermediary relationships and in company law and corporate governance standards do not deal with the public interest aspects of institutional investment management in their corporate governance roles.

By leaving institutions' corporate governance roles as a merely private matter subject to best practices in soft law like the Stewardship Code, policy-makers are able to 'de-socialise' the problem of corporate scandals and savers' investment expectations, framing them as 'market failures' or 'market outworkings'. We, therefore, contend that the public interest in investment management, its outworking for savers and impact on the corporate sector are issues that require public policy and we make a case for regulating institutions' shareholder roles under securities and investment management regulation. We argue that such regulation is able to introduce standardisation of certain expectations of conduct and best practices in order to re-orient investment management towards serving the public interest and to overcome current governance and accountability deficits. Steps are needed to govern those responsible for investment management in order to meet the public interest expectations of delivering long-term savings for investors and maintaining a sustainably wealth creating corporate sector for the future.

¹⁹³ Generally on the nature of open-textured provisions in financial regulation, see J. Black, *Rules and Regulators* (Oxford: Clarendon 1998), although the discussion specifically pertains to the superseded Financial Services Act 1986.

¹⁹⁴ See, for example, C. Ford, 'Macro- and Micro-Level Effects on Responsive Financial Regulation' (2011) 44 *University of British Columbia Law Review* 589; J. Black, 'Paradoxes and Failures: "New Governance" Techniques and the Financial Crisis' (2012) 75 *Modern Law Review* 1037.